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BEFORE THE
SURFACE TRANSPORTATION BOARD
Washington, DC 20423

In the Matter of:	)	
USE OF A MULTI-STAGE DISCOUNTED CASH FLOW MODEL IN DETERMINING THE RAILROAD INDUSTRY'S COST OF CAPITAL	)	STB Ex Parte No. 664 (Sub-No. 1)

REPLY COMMENTS OF ARKANSAS ELECTRIC COOPERATIVE CORPORATION

Pursuant to the Board's decision served August 11, 2008, Arkansas Electric Cooperative Corporation (AECC) respectfully submits the following reply to the comments submitted by the Association of American Railroads (AAR) and the U S. Department of Transportation (DOT) regarding the Board's proposed use of a multi-stage Discounted Cash Flow (DCF) model to complement its use of the Capital Asset Pricing Model (CAPM) in determining the cost-of-equity component of the railroad industry's cost of capital. AECC and its interests in this proceeding were described in the comments it submitted September 26, 2007 in Ex Parte No. 664.

AAR and DOT promote the use of the Morningstar/Ibbotson model referenced in the Board's notice. However, in the comments it submitted September 15, 2008 in this proceeding, AECC discussed the types of errors that may result from use of the Morningstar/Ibbotson model, particularly the portions that rely on analysts' expectations.

The events of the past four weeks underscore at least a portion of the intrinsic reliability problems of methods that rely on analysts' expectations. In the late summer of 2008, the parent corporations of the largest 4 Class I railroads all received ratings upgrades from major analysts. However, anyone who followed the guidance of those analysts saw value of their investment plunge by 19.4 to 29.2 percent in as little as 23 days:

Railroad	Date	Analyst/Upgrade	Price (at Date)	Price (10/10/08)	Change
BNSF	9/10/08	UBS – Neutral to Buy	99.44	80.16	-19.4%
CSX	8/14/08	UBS – Neutral to Buy	61 18	43.31	-29.2%
NS	9/10/08	UBS – Neutral to Buy	65.47	52 05	-20.5%
UP	9/17/08	Longbow – Neutral to Buy	72.76	58 00	-20.3%

Source http //finance yahoo com/

Even after the record-setting rally of October 13, the net losses ranged from 11.7 to 18.5 percent.

Above and beyond this dreadful performance, the prospect of entrusting Wall Street with the determination of the cost of capital – a parameter that serves as a fulcrum for the balance between the private interests of the railroads and the public interest considerations administered by the Board - is quite troubling. Section 10704 (a)(2) plainly reserves to the Board – and not to the private marketplace – determination of the appropriate cost of capital for the rail industry. There is no reason to believe that Congress ever intended for the Board to simply defer to Wall Street on this critical issue, even before the recent debacle.

In light of these considerations, it would be appropriate for the Board to revisit its planned reliance on analysts' expectations in the multi-stage DCF model. This could include, for example, shortening the duration of the first stage and/or changing the logic of the second stage to expand the reliance on the long-term growth of the economy as a critical parameter.[1] It could also mean delaying the use of any new model of this type pending further consideration of the sources, magnitudes and distributions of errors embedded in analysts' expectations.

The Board already improved its cost-of-capital estimation procedure once by getting rid of the analysts' expectations altogether (i.e., when it adopted CAPM). For the reasons presented above and in AECC's earlier comments, the Board should not now act in haste to re-introduce or give undue weight to those expectations.

AECC appreciates this opportunity to participate in the refinement of the Board's cost-of-capital methodology.

Respectfully submitted,

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[1] Such changes would also be consistent with the considerations AECC raised in its previous comments regarding the infirmities of the first two stages of the Morningstar/Ibbotson model, and the important role of the long term growth rate as protection against the possible impacts of rail market power on the validity of the overall results